DOCUMENT RESUME

ED 358 806 HE 026 541

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TITLE	Keeping Score: Direct Student Lending. An Evaluation Prepared for the Iowa College Student Aid Commission and the Iowa Student Loan Liquidity Corporation.
INSTITUTION	North American Education Research Co.
SPONS AGENCY	Iowa Coll. Student Aid Commission, Des Moines.; Iowa Student Loan Liquidity Corp., Des Moines.
PUB DATE	Apr 93
NOTE	49p.
PUB TYPE	Reports - General (140)
EDRS PRICE	MF01/PC02 Plus Postage.
DESCRIPTORS	Comparative Analysis; Experimental Programs; *Feasibility Studies; Federal Programs; Guidelines; Higher Education; Loan Repayment; Paying for College; *Pilot Projects; *Student Financial Aid; *Student Loan Programs
IDENTIFIERS	*Direct Lending; *Iowa; Loan Programs

ABSTRACT

This paper provides recommendations for the development, implementation, and evaluation of a demonstration program designed to assess direct lending as a replacement for the current federal student loan program. It offers a list of principles which the demonstration project should address. Recommendations include: (1) maintenance of student accessibility to loans; (2) testing and evaluation procedures that include representatives of the present system; (3) the consideration of community service and income contingent repayment plans; (4) the need for the states to have an important role; and (5) proportionate student fee reductions reflecting cost savings. The concluding opinion of the report is that the proposed demonstration project should remain a pilot program until it can be demonstrated that direct lending is the better alternative. If that occurs conclusively at the end of the test period, and the operation of parallel systems is deemed impractical, the present system should be replaced and a transition into the new program completed. If the demonstration fails to show that direct lending is the more effective approach, then the present private-public partnership, exhibiting the modifications adopted during the demonstration period, should be continued. (Includes 95 endnotes.) (GLR)

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Direct Student Lending

Keeping Score

An Evaluation Prepared for the Iowa College Student Aid Commission and the Iowa Student Loan Liquidity Corporation

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April 1993

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Brief Biography

William Chance

Bill Chance is Executive Officer of the North American Education Research Company (NORED) and a research consultant with extensive experience in virtually all major aspects of education policy analysis. He also is a former member of the research faculty of the University of Washington's Institute for Public Policy and Management and a past "Scholar in Residence" to the Western Governors' Association.

Chance served as Executive Director of the Washington State Temporary Committee on Educational Policies, Structure, and Management, a blue ribbon panel created by the Washington Legislature in 1982 to study and make recommendations on all aspects of public education in the state. Before his engagement with this committee, he was Director of Academic Affairs at the state's Council on Postsecondary Education, a post he held for twelve years. In this capacity he was responsible for the development of the state's first two long-range higher education plans and a variety of research studies.

KEEPING SCORE: DIRECT STUDENT LENDING

By William Chance, NORED

For the Iowa College Student Aid Commission and the Iowa Student Loan Liquidity Corporation

REPORT ABSTRACT

In 1992, Congress authorized a new federal direct student loan demonstration project. Draft regulations for such a demonstration program were issued by the Department of Education in April, 1993. Meanwhile, the new administration released a proposal that could have the effect of moving directly to a replacement of the present privately-funded guaranteed student loan program by 1997.

The Administration's proposal is heavily predicated on budget savings, based on a GAO estimate of $1.4 billion per year. Cost savings assumptions have been challenged, however, by a variety of analyses prepared in both the public and private sectors. Indeed, most of these conclude that direct lending would prove to be more rather than less expensive than the present system, especially when Congressionally-mandated and industry-sponsored modifications are made.

The case for direct lending rests essentially on arguments of cost-savings and simplified administration. The arguments against direct lending cluster along several dimensions:

1. The federal debt will increase
2. There could be a liquidity problem
3. Presumed savings are illusory
4. Student access to loans could be impeded
5. Students may not be able to rely on loan availability
6. The Department of Education may not be able to manage such a large program
7. Schools will bear increased administrative costs and liability
8. The ancillary services provided by lenders will be lost
9. Loan losses may increase
10. Incentives to remain efficient and responsive could be lost

Still another disquieting concern applies to the increased influence that a student loan monopoly would give the Federal Government over institutions and state higher education policy.

Restructuring of the present program seems a virtual certainty. At least four future program possibilities can be envisioned. The first is the precipitous replacement of the present program with direct lending. The second involves continuation of the present program, with appropriate modifications, while an effective test of the direct lending concept proceeds. The resultant evaluation could lead either to a stronger privately-

funded program, which would constitute the third possible future, or to a direct lending program tested and found to be superior to the present program, which represents a more desirable restatement of the first possibility.

The fourth is the emergence of parallel guaranteed and direct lending programs operated in a continuously competitive relationship.

The case for an adequate demonstration project is compelling. The test and the final result should address the following list of principles:

1. First, do no harm. Students' accessibility to loans to attend and complete college should not be impeded or endangered.

2. The decision process should involve a reliable demonstration and testing program conducted in accord with standards established by and under the purview of a credible independent entity and in a process that permits the presence of representatives of present program participants.

3. The testing effort should be sufficiently comprehensive to ensure reliability of findings; it should address both direct student lending and modifications in the present system; and it should allow the implementation of industry-proposed cost savings during the demonstration period.

4. Evaluation at the end of the demonstration period should include the possibility of parallel private-and government-operated systems (i.e., both GSL and DSL).

5. While repayment options should be pursued, the possibility of incorporating community service repayment and income contingent repayment into both types of programs should be considered.

6. Whatever approach to student lending is adopted, it should be continued as an entitlement program.

7. Loans are not a very good substitute for grants, especially for low-income students. Federally-subsidized loan programs, whatever their form, should not displace grants based on need.

8. Education is the constitutional responsibility of the states, and either program must preserve an important role for them.

9. Direct lending, if implemented, should allow institutions the options to originate, administer, and service loans, enter into consortial relationships to do so, or contract with alternative originators and

servicers. If they opt to service and collect loans, they should receive the same reimbursement as alternate servicers. Timely and appropriate training should be provided.

10. To the extent possible, there should be a single set of rules and regulations carried forward from the present program. Participants' liability should be limited to areas within their control.

11. Institutions should be allowed the option of choice, if a parallel program is adopted, or the latitude to phase in the new program at their own pace, within an agreed upon overall schedule, if it is not.

12. Cost savings from a new approach should be reflected in proportionate student fee reductions.

13. "Reverse revenue sharing" should not occur; program costs should not be assigned to the states or to the institutions.

The concluding opinion of the report is that the proposed demonstration project should go forward in accord with these principles. But it should remain a pilot program until it can be demonstrated that direct lending is the better alternative. If that occurs conclusively at the end of the test period, and the operation of parallel systems is deemed impractical, the present system should be replaced and a transition into the new program completed. If the demonstration fails to show that direct lending is the more effective approach, then the present private-public partnership, exhibiting the modifications adopted during the demonstration period, should be continued.

KEEPING SCORE: DIRECT STUDENT LENDING

By William Chance, NORED

For the Iowa College Student Aid Commission and the Iowa Student Loan Liquidity Corporation

April 23, 1993

"Maxim 777: In every enterprise, consider where you would come out."

Publilius Syrus[1]

"Would you tell me please, which way I ought to walk from here?"

"That depends a great deal on where you want to get to," said the Cat.

"I don't much care where --" said Alice.

"Then it doesn't matter which way you walk," said the Cat.

"-- so long as I get somewhere," Alice added as an explanation.

"Oh, you're sure to do that," said the Cat, "if you only walk far enough."

Lewis Carroll[2]

"O, life is a glorious cycle of song,
"A medley of extemporanea,
"And love is a thing that can never go wrong,
"And I am Marie of Rumania."

Dorothy Parker

I. INTRODUCTION

Recent Events

In 1992, after lengthy and often contentious debate, Congress authorized a new direct federal student lending demonstration project as part of the Higher Education Amendments of 1992.[3] On April 2, 1993, the Department of Education issued proposed rules for the demonstration project ("Federal Direct Loan Demonstration Program.")[4] Meanwhile, on February 17, 1993, as part of its "Vision of Change for America," the new administration issued its proposal to "modify and expand the current direct lending pilot [demonstration] program, with the goal of replacing the guaranteed lending now provided

under the Federal Family Education Loan Program (FFELP), with a direct a loan program in 1997."[5]

Under the Administration's proposal:

> "Federal capital and schools would largely replace private capital and banks as loan originators. The direct lending program is to be built up gradually, to permit development and implementation of the outstanding guaranteed loan portfolio. At the same time, as part of the President's goal of enhancing peoples' ability to work in community service jobs, new systems will be devised to permit eligible borrowers to repay their loans under flexible repayment options, including options where repayment varies with annual income. This will permit many individuals to take lower paying community service jobs without fear of inability to pay their student loan debt. Estimated savings over five years are $4.2 billion, including $1.3 billion in 1997."[6]

Changing Polarities

In light of the Administration and Congress' intense emphasis on budget savings, observers in the nation's capital believe matters have shifted into the "something's got to happen mode, as the Administration's program appears to be overtaking the demonstration project.[7] The matter is more than semantics. While the Administration's February vision statement speaks of a "gradual development process", the goal appears to be linear, full phase-in, rather than the testing, evaluation, and decision sequence implicit in the Congress' demonstration initiative. Because of this, some insist the Administration's priorities have rendered the demonstration program academic.

Whether or not, the introduction of the concept of direct lending into the policy debate has created considerable polarization within the educational institution-student aid-lender-guarantor community. It also has led to what some consider a variety of "Chicken Little" inferences and others view as serious but still unanswered questions about direct lending, the apparent rush to judgement on problems with the old program, and the promised solutions of the new.[8]

The dissension associated with federal student lending programs generally coalesced around the debates surrounding direct lending in Congress, which led to the demonstration project authorization. In effect, the direct lending proposals ("self-reliance loans," "IDEA/self-reliance loans," "UDIC," etc.[9]) reinforced the formation of opinions into two clusters: pro-Guaranteed Student Loan (perhaps admitting need for some modification in the program) and pro-Direct Lending.

After Congressional authorization of a demonstration project and the issuance of draft regulations, the center of interest shifted briefly to that initiative, but it did not seem to alter the intensity of opinions about the merits of the two approaches.[10] Indeed, it seemed that the proposed demonstration fully satisfied neither side. Those who had been opposed to direct lending continued to manifest these feelings in the form of opposition to the pilot test. Those who favored direct lending looked upon the

demonstration program more favorably, but some felt it was too small, too limited, too exclusive, and, therefore, not much more than a design for failure.

The Administration's present determination to move to full phase-in has affected attitudes on both sides. The controversy has shifted from what had become a series of "point-counter point" assertions and dueling methodologies to something approaching genuine uncertainty. Faced with the prospect of a fait accompli in the form of an Administration commitment to the full replacement of the Guaranteed Student Loan (GSL) programs with a Direct Student Loan (DSL) program, as the exclusive federally-supported student loan undertaking, individuals from both sides are now insisting that the pace be slackened. Concerns about the effects of a precipitous program transmogrification on students and their educational plans are expressed by DSL and GSL supporters alike, especially those who work in the student financial aid community. This relates in part to anxiety about an exodus of lenders as the emphasis shifts to direct lending and in part to uncertainties about substantially increased administrative responsibilities. Whatever else, should a new and full-fledged DSL not achieve its promise, it would be difficult to put a superseded and by then completely disorganized GSL program back together.

The distress is over more than the possibilities of GSL babies being tossed with their bathwater. People simply do not understand how a direct lending program will work, what will be the nature of a new and far more ubiquitous role for the Department of Education in state higher educational policy and institutional management matters, whether the new program will be more or less responsive and effective than the present one, and, if it will really save money, what it will cost the states and the institutions. Most of all, they do not know how it will affect students and their educational plans.

While enthusiastic support for the demonstration program was initially a comparatively rare commodity, answers to at least some of these questions were to be found in the testing and evaluation opportunities it offered. Similarly, the demonstration program's parallel operation alongside a GSL program manifesting significant modifications (several important changes were mandated in the 1992 Higher Education Amendments) not only assured the presence of competitive pressure on both ventures but accommodated the very important retention of infrastructure until the decision on which way to go (again, following evaluation) would be made. It also would allow testing the feasibility of permanent parallel governmental and privately operated programs, a subject addressed later in this report. Most of all, it provided time to test the heretofore untried hypotheses, assumptions, and assertions that have characterized the debates about direct lending.

People on both sides now are taking another look at the Congress' initiative and calling for the Administration to slow down until it can be determined whether things will work and how responsibilities will sort out through this medium.

Train Metaphors

Although the skeptics and unsure advocates have not consolidated into a third faction, the frequency with which misgivings over the speed and scope of change and potential negative effects are expressed is increasing. These are aggravated by

consternation that it may be too late to alter events. Train metaphors abound: "The train has left the station;" "The train is rushing down the track;" "How can one switch a speeding train into a siding?" etc.

The situation needs to be placed in perspective. Events are changing rapidly, and it appears that some ultimate restructuring of the student loan programs is certain. This does not mean, however, that people who may be concerned about the direction and pace of change are powerless. Reasonable and feasible strategies are available.

One of the purposes of this report is to identify some of these. To accomplish that, it is first necessary to present the case for a more measured pace. The strongest arguments reside in the fact that no one really knows what the results will be. There is uncertainty and more than a little confusion. Much of this is a carry-over from the conjectures, the aforementioned "count-counterpoint" debates, that have attended the advancement of the direct lending concept. Believability also has been affected by the easy but often unfair insistence that many of the analytical reports are designed to reinforce the biased arguments of vested interests.

Some are polemics, but most are not. The disparities in findings are more often a function of different methodologies. Few are so slanted that they can be considered ipso facto invalid by virtue of the interests of the sponsoring organization. The variance among findings and conclusions more often describes areas of uncertainty and prompts legitimate calls for pause. This will be apparent in the summaries of some of the more prominent studies that are presented below.

There are other reasons for a review of this literature. The issues are complex and hardly user-friendly. Technical terms (during less euphemistically inclined eras called jargon) thrive. It is particularly difficult to understand this play without a program. Moreover, the pace is so great that even the keenest observers have difficulty following the action. Definitions become skewed, and heated debates form over what prove to be misunderstandings. Thus, some of what follows is old but necessary. The intentions are to demonstrate the presence of profound uncertainties and amplify the call for reflection.

This review begins with a description of the GSL programs and the direct lending initiatives. Here a personal opinion might be appropriate: so far most of the debate has centered on technical aspects of the two loan systems; little has been said about the possible effects of program change or modification on student access to higher education. Students must be brought back into the equation. The importance of this contention is demonstrated by the pertinent descriptive quantitative material, almost all of which is either preceded by dollar signs or followed by percent symbols. Data on numbers of students, as distinct from numbers of dollars, are unusually hard to come by, emphasizing by their sparsity a need for a continuing reminder to consider student interests.

These brief program descriptions are followed by a critique of the prominent points concerning disparate cost estimates, along with some of the commentary concerning budget scoring, potential affects on debt, etc. Issues associated with program administration are then examined. The shift to greater program centralization also bears implications for the states and the political-higher education relationships that have developed within their respective political cultures. Some of the implications of the new

federal presence are considered at this point. Finally, the report concludes with a series of observations and recommendations.

If the preferences behind this assessment could be simply stated, they would favor a public-private relationship in the form of a simplified privately-financed lending program. There are many reasons for this, including a predilection to fix things rather than replace them. They also involve a pesky and perhaps ingrained uneasiness about extending so much potential control over public higher education policy to the Federal Government and its minions. Perhaps regrettably, however, a serious debate about the future directions of American federalism may be academic at this point.

Whatever the final program, it must address the interests of students. The question is, which of the choices will best forward those interests, GSL, DSL, or another? The answer should be sought in a rational manner. That will require objectivity, experimentation, evaluation, and a little patience. These require time. A conscientious test via an adequate demonstration project, on the one hand, and efforts to progressively simplify and streamline the present programs, on the other, meet these criteria. These are reasonable courses to pursue.

II. DIRECT LENDING VIS-A-VIS THE GUARANTEED STUDENT LOAN PROGRAM

To appreciate the nature of the GSL/DSL alternatives it is necessary to understand how the present program operates and how the proposed substitutions would change that. This is why the immediately following several paragraphs are presented.[11] These may be skipped by readers already familiar with the two approaches.

The Advent and Development of the GSL Program

The federal government did not become a major participant in the student aid enterprise (nor, for that matter, did many of the states) until the late 1950s, when, as part of the nation's Post-Sputnik response, Congress enacted the National Defense Education Act, which contained provisions for loans for students in need of financial assistance (NDEA loans proved to be the forerunners of today's Perkin's loans).[12] In 1965, Congress enacted the Guaranteed Student Loan Program, which was directed primarily to the needs of students from middle-income families. By the mid-1960s, a combination of federal programs (grant, loan, work) was in place.

During the next few years, pressure grew not only to increase aid but to make it more predictable. Students applied to banks for guaranteed loans, but the other forms of federal aid were awarded by the institutions from federal appropriations. This created problems with packaging (combining federal, state, institutional, and personal resources into an appropriate financial program for the student), and students had no way of knowing the aid that might be available until they had applied and been accepted at college.[13]

In the early 1970s, the Basic Educational Opportunity Grant program (now called Pell Grants) was created to provide a foundation on which might be added aid from other sources. Application was direct to the federal government, and the amount awarded was

determined without regard for where the student actually enrolled. The BEOG program was accompanied by State Student Incentive Grants (SSIG), which were intended to induce states to expand their own grant programs. In 1978, Congress approved the Middle Income Assistance Act, and Pell Grant eligibility was moved up the income scale. All students, regardless of family income, were made eligible for GSLs.[14]

During the immediately ensuing period, high national inflation rates rendered the GSLs, with their seven percent fixed interest rate, very attractive to borrowers, and loan volume expanded, increasing the costs associated with federal loan subsidies as well. The subsequent election of President Reagan and the new administration's determination to cut back on social spending, including federal student aid support, prompted a series of proposals, most defeated by Congress, to that end. The net effect, however, was a slowdown in the growth of federal aid. During the next several years, the 1978 eligibility changes were repealed, and various changes were implemented to restrict guaranteed loans to those who could qualify on the basis of need. Also during this period, the name of the GSL program was changed to the Stafford Loan Program. Two new loan programs, the Parent Loans for Undergraduate Students (PLUS), an "unsubsidized" version of the Stafford Loans for parents regardless of income, and the Supplemental Loans for Students (SLS), which increased access to loans for students not dependent on their parents, were created.[15]

The FFELP Programs

Presently, the four basic types of federal loan programs -- Stafford Loans, Stafford Unsubsidized Loans, PLUS, and SLS -- comprise the Federal Family Education Loan Program (FFELP).[16] While most of the present interest centers on the first and largest of these, Stafford Loans, all share several common characteristics:

They convey a federal guarantee to the lender against loss through borrower default;

They provide a guarantee of a competitive return on the investment to the lender; and

They guarantee to the student borrower that the interest rate charged on the loan will not rise above a specified rate.

The competitive return to the lender is assured by a "special allowance" payment (SAP), which is based on an authorized margin added to the 91-day Treasury bill rate. If the borrower's interest rate drops below this yield, the Federal Government pays the difference. This allowance was reduced by the Higher Education Amendments of 1992 to the ninety-one day Treasury Bill note rate plus 3.1 percent from the former allowance of 3.25 percent, with a cap of nine percent (the previous rate was eight percent for the first four years of repayment, rising to ten percent thereafter).[17] These programs are designed to serve students with differing needs. While borrowers must demonstrate

financial need for Stafford Loans, this is not required for PLUS and SLS. Stafford loans are intended for students whose personal or family incomes are insufficient to meet education costs. PLUS is directed to dependent students whose family incomes are considered sufficient to meet such costs. SLS is intended for independent students. Borrowers are regularly allowed 10 years to repay the loans (under the Consolidation Loan Program they may combine multiple student loans and extend the repayment period).

During the 1988 Congressional hearings on defaults in the GSL programs, Representative Pat Williams offered the following comment on their evolution as a social program: "First, the purpose of the guaranteed student loan program, originally established as a loan of convenience for middle income students [sic] has changed significantly during the last decade, becoming the primary program for access to postsecondary institutions by low income students."[18]

Stafford Loans amounted to nearly 83 percent of all outstanding GSLs in September, 1991.[19] As the largest of the FFELP programs, Stafford Loans also serve as the focal point of the discussions between guaranteed and direct student loans, and serve, accordingly, as a common synonym for GSLs throughout this report. The Stafford Loan Program is available to undergraduate, graduate, and professional students without established credit, based on need. While the student is in school, and for a six-month grace period after graduating and leaving, the government pays the interest on the loan, as it does during any subsequent periods of repayment deferment (e.g., during unemployment). The government also pays the difference between the student's interest rate and a competitive return to the lender during the student repayment period.[20]

Five GSL Functions

According to the Congressional Research Service, the GSL programs involve six distinct groups in the effort to deliver subsidized loans to students. These are: students (borrowers); postsecondary education institutions; commercial lenders; guaranty agencies; secondary purchasers; and the Federal Government. The process involves five key functions. An appreciation of these is crucial to an understanding of much of the rhetoric associated with the GSL-DSL debate. Thus, also according to the CRS, these are the following.[21]

1. **Loan Origination**: Guaranteed loans to students are provided primarily by commercial banks, savings and loan institutions, and credit unions (private lenders). As a general rule, however, students do not go to the lending institution to apply. Rather, the application process is handled by the postsecondary institution, and it consists essentially of a check on eligibility. A five percent 'origination fee' is deducted from the loan principal and paid to the Federal Government (even though the commercial lender is the originator).[22]

2. **Guarantee**: The Federal Government guarantees that the loans will be paid (and that the lender will receive a competitive return). The term conventionally applied to the default guarantee is "reinsurance," since the lender actually receives "insurance" on the loan from a state guaranty agency, which has an agreement with the government to reimburse it for any defaulted principal and interest payments it makes to lenders.

3. **Reinsurance Servicing**: The state guaranty agencies (or the private or nonprofit guaranty agencies designated by the state -- the different types of guaranty agencies are described later in this report) service the Federal Government guarantee. They ensure student eligibility and compliance with federal rules and that appropriate procedures are followed. They may receive an insurance fee from each student borrower (from zero to three percent of the guaranteed loan principal). They also may keep 30 percent of all collections on defaulted loans. Since they insure the loan, they are at risk only if the default rate is more than five percent or higher, in which case the federal guarantee would repay only 90 percent (or 80 percent if defaults exceed nine percent of the volume of loans in repayment).

4. **Investment**: The commercial lender receives interest payments intended to be competitive with its alternative lending opportunities. While lenders originate the loans, not all hold them in their investment portfolios. These may be sold in a secondary market, particularly after the student leaves school (the Federal Government makes interest payments while the student is in school) and loan servicing requirements occur. The secondary market is dominated by the Student Loan Marketing Association (Sallie Mae, which is a government-sponsored entity created to purchase these loans). Other secondary market participants include 42 state or non-profit entities and some large commercial banks. Selling to a secondary market both allows lenders to avoid the tribulations of loan servicing and provides a source of funds, liquidity, to make additional student loans.

5. **Loan Servicing**: According to the CRS, "Most student loans tend to be for relatively small amounts of money (averaging $2,875 in 1982), which combined with the regulatory servicing burdens, mobility, and uncertain income stream of recent postsecondary graduates and dropouts, makes student loan servicing expensive relative to other types of loans."[23] This function, therefore, has been largely assumed by organizations (including some guarantor and secondary agencies) that specialize in loan servicing and work on a contract basis with the lenders.

The GSL program provides guarantees for some $15 billion in privately-funded loans to students per year. More specifically, the program has grown from 89,000 loans for $73 million in 1966 to 5.1 million loans for $14.6 billion in 1992.[24] Through fiscal year

1991, some $127 billion had been loaned under the combined GSL program. As noted earlier, Stafford loans account for more than eighty percent of the total.

Program delivery requires a comprehensive system. In the words of the GAO, "The Stafford program is a complex, multilayered delivery system. This system involves over 8,000 educational institutions, 10,000 commercial lenders, 45 state or nonprofit agencies, and 35 secondary market institutions."[25] There is no reference in this popular summary to numbers of students served by the GSL delivery system.

Students Receiving Loans

This section will be brief. For reasons that are not entirely clear, data on the numbers of students participating in the GL programs is sparse, as tables and graphs are almost invariably devoted to millions of dollars. This may explain the concerns of financial aid officers that students have been lost in the din of the discussions of the many aspects of the GSLs and their replacement with a DSL program.

According to the Department of Education, 20.5 percent of the undergraduates enrolled in Fall, 1986, were recipients of GSLs (exclusive of PLUS). This converts to approximately 2.3 million such students that year. During that same year, GSLs were awarded to 25.3 percent of post-baccalaureate students, or approximately 344,000 students, for a grand total of approximately 2.6 million.[26]

This figure does not offer much guidance for anyone seeking a cumulative year program total, and the Department's statistical digest does not provide multi-year or program-life total information about students receiving loans. Nor, unfortunately, is there much in the way of moderately accessible material on numbers of students involved in the program during the years since 1986. The most commonly-cited figure of the total number of students served through federally-sponsored student lending programs is the Department's estimate of 22 million.[27]

The Default Issue

Speaking to the GSL default issue during the aforementioned 1989 House Labor and Education Committee hearings, Representative Williams offered this advice:

> "Of the fiscal year 1988 budget of $3.4 billion dollars for the GSL program, about $1.6 billion will represent default cost. Such a cost is cause for concern, but it has to be looked at in the context of what has been happening to our student aid efforts during the past decade.
>
> "One occurrence is that those students who should be the least reliant on loans have become the most reliant. Students for whom we have developed grant programs to assure access to higher education have had

to rely on ever greater degree in loans because grant funding has not been sufficient to meet their needs.

"Since 1980, the Pell Grant maximum has increased only 26 percent. while the CPI increased more than 40 percent. The $2,200 Pell Grant maximum [$2300 in the proposed Administration budget], which goes only to the lowest income students, will cover about 29 percent of the average college costs. As a result, these low income students have been forced to borrow larger amounts in ever greater numbers.

"It is important to note that the default rate has not increased in the past few years. In fact, the opposite has occurred.

"According to the Department of Education, the rate of default has decreased since 1978; however, during the same period of time loan volume has increased from just a little below $2 billion annually to more than $8 billion annually.

"This more than 300 percent increase in loan volume has inevitably brought with it increased default costs."[28]

Defaults now comprise about 15 percent of loans in repayment. In 1991 they totaled approximately $3.25 billion.[29] *Iowa's default rate, seven percent, is lower than the national figure.*

As to perceptions, the National Commission on Responsibilities for Financing Postsecondary Education seems to agree with Representative Williams assessment: "The reasons why students default on their loans are complex. Contrary to the myth of 'deadbeats' unwilling to repay their loans, the vast majority of defaulters are those who are unable to repay their loans. The research also suggests that the strongest indicators of default include dropping out of school and attending a non-collegiate [e.g., proprietary school] institution. . . Research . . . also shows that students from low-income families default at disproportionately higher rates than others. Therefore, as low-income students have increased their borrowing, defaults have continued to escalate."[30]

The point need not be belabored here, but one financial officer interviewed during the course of this report's development noted that had the growth trend in default rate prevailed from when the program was operated by the Department of Education, the present rate would be close to 25 percent even without the expansion in the presence of students from non-collegiate schools that has since occurred.

The growth in non-collegiate school participation is important. In 1986-87, over 70 percent of the students in these schools took out GSLs, of which more than 80 percent were over $2,000. The figure compares with 26 percent of the public institution undergraduates. *That year non-collegiate school borrowers accounted for about 30 percent of the Stafford program loans and 48 percent of the defaults three years later, compared with 65 percent of the loans to four-year institution students, who accounted for about 12 percent of the defaults.*[31]

Separate reports have been written on the default subject. The matter is addressed here because it is not widely understood. It also represents part of the combination of concerns about costs that has given impetus to efforts to improve or alter

the present system, some of which have manifested themselves in calls for direct lending as a replacement for GSL. A few words on direct lending are appropriate at this point.

The Direct Lending Initiatives

The idea of direct student loans from the Federal Government is not new. In his prepared statement for the Senate Committee on Labor and Human Resources during the 1992 hearings on the subject, Senator Kennedy tracked the idea to a 1954 suggestion of Milton Friedman. He also cited Boston University President John Silber's 1970s call for the establishment of a Tuition Advance Fund, "which would combine direct federal lending to students with income-contingent repayment."[32] As noted earlier, Perkins Loans, "lineal descendants of the National Defense Education Act of 1958," are direct loans.[33]

More recent Congressional action took the form of authorization of a demonstration program in the 1992 Higher Education Amendments. Direct lending has caught the attention of the present Administration, and it is addressed among the recommendations of National Commission on Responsibilities for Financing Postsecondary Education.[34] The essential features of the Commission's recommended program generally apply to contemporary conceptions of direct lending programs. Ancillary elements, such as income-contingent repayment arrangements, service and collection by IRS, and forgiveness arrangements for community service, accompany the major direct lending proposals, but these are not sine qua non nor need they be limited to direct lending. They could be employed in a privately-funded loan program. And, as exemplified by the Perkins Loan program, they are not necessary to direct lending. The point is relatively important, since there exists some tendency to treat them as constituent parts. This has contributed to some confusion.

Arthur Hauptman made an effort to clarify the situation in his February 6, 1992 testimony before the House Education and Labor Committee's Subcommittee of Postsecondary Education: "Direct lending is a question of the source of capital for student loans. The provision of the in-school interest subsidy involves who should receive government benefits. Income contingency is a repayment issue. IRS involvement raises the question of program administration. Each of these issues is controversial in its own right and deserves serious consideration. The public policy debate, in my view, is not enhanced when these issues are all lumped together and debated collectively."[35]

In its report, the National Commission called for "the replacement of the current bank-based federal student loan structure with a direct loan program that allows students the option of repaying their loans on an income-contingent basis through the IRS."[36] Essentially, the Commission recommended replacement of the present FFEL program's five components with three: a subsidized student loan program; and unsubsidized student loan program; and an unsubsidized parent loan program. Borrowers could choose to repay their loans either on an income contingent (which would be through IRS, which "would act as a loan servicing/collection agency") or conventional basis. Programs would be funded through Treasury borrowing via the sale of government securities to investors. According to the Commission, "Moving away from the current system of private sector

capitalization -- with heavy government subsidies for banks and guarantee agencies -- would generate savings of at least $1 billion per year". The Commission viewed such a program as a replacement for the present ones and not as an additional entitlement program under the federal budget.[37]

Under the Commission's proposal, institutions would serve as loan originators and "as agents for the federal government." They would originate loans in a manner similar to the Perkins Loan program and the envisioned Direct Loan Demonstration project. Loans not serviced and collected by IRS (i.e., the income contingent payback version) would be handled by private organizations through contractual arrangements with the federal government. The Department of Education also would be obliged to establish and maintain a student data system as a central source of information on all student borrowers."[38]

Loan amounts and interest charges vary with different direct lending proposals. In the Commission's Subsidized Student Loan Program, interest on loans would not accrue while students were in school. The rates would be equal to that of T-bills plus a fixed amount to cover program costs (exclusive of default costs). The Commission recommended that this not be more than two percent. The allowed loan amount would be the proportion of $14,000 (in 1992 dollars, "the amount spent to instruct and educate each student at four year institutions") not made up of grants, work-study awards, and student/family resources, including unsubsidized loans (the combination varies by family income in the Commission's "Student Total Education Package [STEP]" program). The Commission also recommended unsubsidized student loan (interest accrues throughout the life of the loan) and unsubsidized parent loan programs.[39]

In determining costs, and wishing to avoid prolonged debates over that subject, the Commission relied heavily on extant estimates of cost savings in its call for such a program. It cited the Congressional Budget Office and General Accounting Office estimates that a GSL phase-out and replacement with a direct lending program would save approximately $1.4 billion. This would offset the added costs ($1.5 billion annually) created by the Commission's recommended higher loan limits in the subsidized and unsubsidized direct loan proposals. The Commission was unable to estimate costs or savings associated with the income-contingent repayment provision, although it made reference to a possible annual savings of $1 billion in the precluded defaults such a payback option might offer.[40]

The Federal Direct Loan Demonstration Program

Similar assumptions, including estimates of savings, figure prominently in most DSL proposals. In his prepared statement to the Senate Labor and Human Resources Committee, Senator Kennedy offered these reasons for considering direct lending:

> "First, according to estimates from the General Accounting Office and the Department of Education, a direct loan program will save substantial amounts over the current program.

"Second, There is greater ease for both the borrower and the government. A direct loan program will have fewer middlemen and be easier to manage than the existing loan program. A direct loan program will be simpler for students and their families, and may well be much simpler for the Federal Government.

"Third, income-sensitive repayment [through] the Internal Revenue Service will both streamline the repayment process for borrowers and allow graduates to choose employment after college without fear of being financially over-burdened if they choose lower income employment. Finally, by collecting through the Internal Revenue Service, we are likely to reduce loan defaults."[41]

Senator Kennedy also realized a need to move cautiously, and he followed the above summation with this statement:

"But just as there are reasons to move in this direction, there are reasons to move with care. Despite its many problems, the current Guaranteed Student Loan Program services millions of students a year and makes it possible for them to obtain a college education that might otherwise be beyond their reach.

"In addition, a direct loan program will require the Department of Education to assume a number of new administrative functions that it is not currently performing. Despite improvements under Secretary Alexander, the department remains a thinly staffed agency with questionable ability to undertake major new administrative responsibilities, let alone perform its current responsibilities adequately.

"Thus, we propose testing a direct loan program to gauge its benefits while being able to measure the government's ability to administer it. The potential benefits of direct lending with income-sensitive repayment are too great to ignore. The two most important criteria in considering this initiative are: Is it better for students, and is it cheaper for the Federal Government?"[42]

Senator Kennedy was not the only one offering an admonition. Senator Orrin Hatch of Utah offered this:

"I'd like to see a better system. I'd like to see more opportunity. I'd like to see more young people benefit from our programs up here. But I think we need to look at this issue very carefully.

"No. 1, this adds another new loan program to an already complex set of loan programs. No. 2, it makes an entitlement out of an untested program. . .

"No. 3, it potentially shifts decision-making away from the Committee on Labor and Human Resources and toward the Finance Committee

because of the collection by IRS that will be required. That concerns me a great deal.

No. 4, many institutions may not be capable of carrying out these new responsibilities or, if they are capable, this may add a great deal more paperwork and difficulties for them.

"I have heard all the arguments that this will reduce paperwork and make a nirvana that we haven't reached before in the higher education system, but we all know that this is never true in the Federal Government.

"No. 5, the Department of Education may not currently have the capability to run this program.

"No. 6, the IRS may not be capable of making the needed changes quickly enough with the tremendous problems they have.

"No. 7, I think there are a lot of questions that need to be answered, . . .

"And No. eight, I think this program will encourage young people to go further into debt. . .

" . . . I think [this list represents] a very serious set of concerns. However, I am very interested. . . in perhaps trying a pilot program or a demonstration project to see if it works. I'm all for it. But I sure as heck don't want to make a drastic change like this unless I know it works.[43]

In responding to Senator Hatch's concern, Senator Simon, one of the sponsors of the plan, said, "That's what this is; we're talking about 300 schools."[44] His reference was to the proposed demonstration project, which would be, in the words of Senator Kennedy,

". . . a pilot initiative that will permit us to test the direct loan approach, with students repaying their loans through the Internal Revenue Service after they leave college. Under our plan, . . . a diverse group of 300 schools will be chosen by the Secretary of Education to participate in . . .a supplemental loan program in addition to the current Pell Grants and Guaranteed Student Loans.

"Schools will borrow the money from the Federal Government and make loans to their students. Any student at a participating school will be eligible for a loan. Students can receive up to $5,000 a year, with a total borrowing limit of $30,000. The money will be lent to students at an interest rate equal to the 52 week rate on Treasury bills plus 2 percent. If the plan were in force today, students could borrow money at about 8 percent.

"The loans will be repaid through the Internal Revenue Service by increased withholding. Before leaving college, borrowers will be given a choice of repayment options developed by the Secretary of Education and the Commissioner of Internal Revenue. Borrowers will continue to make payments until the loan is repaid. After 25 years, any further indebtedness would be canceled.

. . .

"This plan is intended to test the viability of the direct loan approach. If the idea works, I am certain Congress will want to expand it to more schools and more students. If the test does not succeed, the program will be terminated."[45]

All of these people recognized the untried nature of the concept, the possible shakiness of many of the assumptions necessary to its success, and the potential consequences of a precipitous and unsuccessful change. Just as there is enough promise in the proposals to warrant consideration, so is there enough uncertainty to warrant prudence. Here are some of the reasons behind both views.

Prominent Direct Lending Questions

The President's budget lists the following benefits of a direct lending program:

"By using low-cost Treasury borrowing instead of subsidizing private lenders, direct lending will reduce federal costs by $4.2 billion in outlays through 1997, while at the same time reducing the interest rates for borrowers in 1997.

"Delivery will be simpler: no delays for obtaining lender and guarantee approvals before funds are disbursed, automatic consolidation of multiple loans for consolidation, no confusion about who holds the promissory note, and greater ability for the institution to change the amount of an individual loan."[46]

Some of the more conspicuous worries, paraphrased from a variety of sources, are these:

1. The Federal debt will increase under direct lending

The program will be funded by the issuance of federal debt. Annual increases to the debt ceiling of $15 to $20 billion each year will be required. Present federal loan programs cost approximately $5.5 billion and leverage $15 billion in private loan capital. Direct lending of comparable volume would require $15 billion in additional treasury borrowing plus funds to cover the costs of program administration.

2. Direct lending proposals have not addressed the liquidity function

There is a matter of liquidity. In the words of Deloitte Touche, "Even if you could make the gigantic leap of faith that the federal government could effectively administer the program [see below], the direct loan concept as proposed is fatally flawed because it does not address the liquidity function.

Five years after a direct loan program began, the federal government could easily have $75 billion or more in student loans to administer. Government capital (much of which would itself be borrowed) would be increasingly tied up in low rate student loans with average lives of 12 to 14 years."[47]

3. The presumed savings of direct lending are an illusion

The Congressional Research Service reports no inherent savings from a change to direct lending.[48] Indeed, the CRS study advises that budget outlays could increase if a direct lending program were unable to duplicate administrative efficiencies achieved by private lenders.

Credit-reform budgeting makes direct lending appear attractive because it does not count the outlays for loan volume against the budget.

The Congressional Research Study[49] concluded that the GAO projections of savings were wrong in that GAO failed to take into account the current interest-rate environment that makes the present loan program substantially less expensive (rather than, as claimed, more expensive). These projections also ignored the substantial changes being imposed by the industry and by virtue of reauthorization to make the programs more effective, and they seriously understate loan servicing costs under direct lending, transfer a sizable portion of loan program administration costs from the Federal Government to the institutions, and ignore the costs of phasing out the present program. (Note: these studies are reviewed in more detail in the following section of this report.)

In effect, direct lending would substitute massive federal borrowing and the creation of an enlarged federal bureaucracy for the present program's reliance on leveraged private capital and banks for loan origination.[50]

4. Student access to loans would be threatened if private loan capital were to dry up during a transition to a direct loan program

There is some fear that lenders would immediately cease participation in the current GSL program if a decision is made to replace it with a direct lending program. Should lenders begin to leave the program when direct lending is adopted instead of waiting until the last days they are permitted to lend, there could be several years of shortages of loan funds.

Phasing-in a new, unproved program before the essential infrastructure is in place is a high risk strategy -- one that could prove disruptive for many students and institutions. The Administration effort assumes that all the present loan program participants will continue to provide essential capital

and administrative support throughout the phase-in period to students and institutions not yet involved in direct borrowing. At the very least, for economic reasons banks will be forced to stop lending to high risk borrowers, and this would have a disproportionate effect on vocational/technical school and community college students.

5. Students may not be able to rely on the availability of direct loans

Under the present GSL system, loan capital is available on demand regardless of the stage of the academic year in which application is made. In the words of a Sallie Mae assessment provided by NASFAA, "The inherent constraints of a federally directed system prevent the delivery of funds to students from being as efficient or reliable as the current model. This is because of the built-in limitations of any single source of funds system; the time-consuming cumbersomeness of annual school-by-school applications for funds based on estimates of need and demand, which are then reviewed by the Government for reasonableness; and because there is no market-driven incentive for the Government to move expeditiously to approving and supplying the needed funds. In point of fact, the Government saves money as the delivery system bogs down and funds are held longer by the Treasury."[51]

Others note that the greatest loan application volume occurs in the Fall, as students return to school. This also is near the end of the Federal fiscal year. Thus, the Department would be processing massive numbers of loan applications at the very time it would need to close its books on one year and open those for another. The prospect is disturbing.

Returning to Sallie Mae/NASFAA, "When direct loan funds are not delivered when needed, schools will have no choice but to, in effect, provide the necessary interim student financing from their own resources. Students attending schools that cannot provide this 'float' will be unable to meet these educational costs and may have no choice but to withdraw."[52]

6. The Department of Education may not be able to administer a direct lending program efficiently and effectively

The Department has said this, and there is no reason to doubt its conclusion.[53] Some have observed that the 1991 GAO report on direct loans noted that both the General Accounting Office and the Inspector General "identified substantial accountability problems related to the Department's management of guaranteed student loan programs. For example, in April, 1991 we found that the Department's Student Loan Insurance Fund could not be audited. In addition, in March, 1991, the Office of the Inspector

General and the Office of Management and Budget completed a study that found that the Department's management practices contribute to high default rates, fraud, and abuse in guaranteed student loan programs."[54] More recently, the GAO "identified material weaknesses in the Department's ability to obtain accurate and reliable data on the GSLP."[55]

Others note that the Department has taken several hard budget hits in recent years and is presently understaffed. On the subject of program administration, Senator Kennedy, for example, stated ". . . a direct lending program will require the Department of Education to assume a number of new administrative functions that it is not currently performing. Despite improvements under Secretary Alexander, the department remains a thinly staffed agency with questionable ability to undertake major new administrative responsibilities, let alone perform its current responsibilities adequately."[56]

Moreover, shifting from the present public-private partnership with its incentives for innovation, flexibility, and responsiveness to a centralized bureaucracy relying on low-bid federal contracts could lead to a significant deterioration in service levels to students and institutions.

7. Schools will bear increased administrative costs and liability with direct lending

While some institutions have expressed interest in participating in direct lending, many doubt they have the financial, administrative, and systems resources to administer such a program. So far there is no indication that the costs associated with direct lending will be reimbursed. They could be substantial. Sallie Mae estimated that "Schools would have to invest more than $400 million of their own resources to prepare for administering the loans, and take on administrative costs of up to three times greater than the $20 per loan it is proposed they receive for their services -- an additional $120 million per year out of . . . their pockets."[57] Estimated costs for Iowa colleges range between $3 and $6 million per year.[58]

Regardless of how it is paid for, direct lending will require institutional staff additions for administration. Colleges and universities are presently criticized for more rapid increases in their administrative than their teaching staffs.

Schools also may bear increased responsibility for unsigned or lost promissory notes, loans in excess of annual and cumulative dollar limits, and other errors that affect collectability. Institutions will continue to be responsible for informing the Federal Government or its servicing agent of

student status, address changes, eligibility for deferments, etc. Failure to do so in a timely manner could cause the government to assess liability against the school.

In addition, for years after direct lending is adopted, institutions will have to administer two programs. Their administrative responsibilities under the present program will continue while they assume full responsibility for a new program, a new data base, and new regulations.

Still another concern is over schools that have posted high default rates and offered questionable educational programs being placed in a position through direct loan program administration that would be tantamount to a direct draw on the Federal Treasury.

8. An array of ancillary services provided by guarantors and private lenders will be lost under direct lending

Many institutions depend on the assistance of outside professionals to interpret complex federal regulations, counsel students about lending, train staffs, generate customized reports, and process loan applications. Guarantors and lenders alike have an interest in providing this assistance, since all have responsibilities for preventing defaults. The value added to the program by these services and by the private sector's huge investment in supporting technology will be lost under direct lending.

9. Loan losses may increase under direct lending

Students presently are assisted by guarantors both in converting their loans to repayment in a timely manner and in managing their debt. If the government is unable to provide such assistance on the scale required, a significant increase in defaults could be the result. Even students who did not default might find themselves over-indebted.

10. Lack of competition in a federally-operated direct lending program will result in no incentive for the government to be responsive to institution or borrower needs

Were the Federal Government to be the "only game in town" there would be no leverage for schools or borrowers. The competitive nature of the present program has led to such innovations as a combined application-promissory note, rapid turn-around on loan guarantees, electronic disbursement, and comprehensive training programs and information disbursement. Incentives for such innovations would be lost under a government-managed direct lending program.

These exemplify the most frequently expressed uncertainties. Others are directed at the prospect of IRS involvement in collections ("The IRS has a dismal record when it comes to counseling") and the income-contingent and community service components of the president's proposal, but there is much support for the latter, even among proponents of the present system. Since neither of these are necessarily uniquely tied to direct lending, there is no real need to explore them here.

The major problems cluster along three dimensions: cost considerations; program administration considerations, and federal-state-institution relations considerations. A brief review of these follows.

III. COST CONSIDERATIONS

There is little disagreement that the present GSL program gets necessary funds out to students in sufficient amounts. This has not always been the case with federal student loan programs, and the present structure came about because of a desire in the mid-1970s to increase liquidity, to get more private capital into the endeavor. In that respect the GSL program has succeeded admirably. Thus, the case for a replacement is not argued in terms of student benefits, i.e., in terms of making more money available to students or otherwise improving their condition.[59] Similarly, references to savings for student borrowers have not been encountered, although the benefits of an income-contingent repayment option and 25-year forgiveness are clear.

Rather, the case is argued in terms of cost savings and simplified administration. Right or wrong, the controlling question at present is whether the program will save the government money. On the surface, at least, that would seem so: few can borrow money more cheaply than the feds. A point or so shaved from the interest rate and elimination of the special allowance payment should save money. Reduced defaults through IRS collection, a more tenuous assumption, also would seem to save some money, perhaps at some cost in bad feelings.

The question is not that simple; the dispute revolves around whether there would be savings or costs, how much, and, if there were savings, whether they would be offset by increased costs of program administration.

The initial and what have become conventional estimates of cost savings trace to the GAO report, "Student Loans: Direct Loans Could Save Money and Simplify Program Administration."[60] That report's assumptions rest on changes instituted by the Credit Reform Act of 1990 (PL 101-508). This brings up the subject of "budget scoring."

Budget Scoring

According to the GAO, before the Credit Reform Act, budget rules were biased in favor of guaranteed loans and against direct loans: "Under the old rules, a guaranteed loan's cost consisted of interest subsidies and loan defaults in the year federal funds were appropriated, regardless of future interest subsidies and defaults. A direct loan's cost was equivalent to the outlay for loan principal. Subsequent defaults and repayments were accounted for in the year they occurred, not when the loan was made. As a result of this

accounting method, direct loans appeared much more expensive than guaranteed loans. . . Under the new rules, the budgetary cost of each program for a 1-year loan cohort is the net present value of all costs associated with those loans. A guaranteed loan's cost is the discounted value of all interest subsidy and default costs, while a direct loan's cost is the initial outlay less the discounted stream of anticipated principal and interest payments."[61]

The significance of this new method of accounting derives from the fact that, in the words of the Policy Economics Groups of KPMG Peat Marwick, in a time of huge actual and anticipated deficits, concentration on the budget is unavoidable: "The budget rules have become extremely complex and the budget scoring of the costs of a program can mean its life or death. Moreover, the dominance of budget considerations and the attractiveness of proposals that can be said to result in deficit reduction have led to some questionable policies and programmatic decisions."[62] The report notes that the new approach inaugurated by the Credit Reform Act represents a significant improvement in some respects, but "it is now strongly biased against the existing student loan program and in favor of direct government loans."[63] According to the authors, the three "most significant biases" are:

> **1. Failure to fully account for administrative costs.** "Because the compensation [of private lenders for their administrative costs] takes the form of an interest payment, it is counted as part of the subsidy. The scoring of the first-year cost of a guarantee program, therefore, includes the present value of most administrative costs, whereas the scoring of a direct government loan program records all administrative costs on a year-by-year cash basis, and only one year's administrative costs are charged against the first-year cost of a direct government loan program."[64]
>
> **2. Failure to account for indirect financing costs.** "The substitution of direct government lending for loan guarantees sharply increases the supply of public debt on financial markets while reducing the supply of bank deposits and other securities used to finance guaranteed loans." Some effect on the relative rate on public debt is likely. "Because the federal government will raise considerably more than $1 trillion per year in the next few years, a tiny effect of, say, two basis points is sufficient to wipe out all of the saving claimed for direct government loans over loan guarantees. (Each basis point has a present value of well over $2 billion.)"[65]
>
> **3. Likely increase in costs from Federal management.** There also is fear that the Department will not be able to administer such a program efficiently, and that there will be increases in default rates, abuse, and fraud, and that administrative costs will rise. This could consume a significant part of the estimated savings. The cost estimates of the GAO fail to take this possibility into account.[66]

Perhaps more important, the contradictory relationship the two programs (GSL and DSL) bear with respect to the effects of the Credit Reform Act and budget scoring -- i.e., estimates of cost savings are a function of an accounting convention -- reduce confidence in the claims surrounding direct lending (e.g., "The presumed savings are an illusion.") They derive from a procedural practice that may not be sustained by direct lending's substantive effects. The present atmospheric emphasis on cost savings and the resultant commitment to full phase-in of direct government lending without prior testing and evaluation contribute a political connotation that stimulates skepticism and mistrust.

The GAO estimate of cost savings

To determine relative program costs, the GAO compared the cost of a one year cohort of loans under DSL and GSL, exclusive of transition costs ("We estimated the total cost of loans made in 1 year. In accordance with credit reform, this involved estimating the future costs of these loans on a year-by-year basis and then discounting these costs back to the initial year."[67]) Using a cash-flow model, and including some, but not all of the costs associated with administering the programs (fees paid to loan servicers in the direct loan program and an administrative cost allowance in the GSL were included; Department administrative costs in either program were excluded.) The bottom line was a GAO estimate that "A direct loan program operating in place of the Stafford loan program could save over $1 billion -- present value terms. . ."[68] This would be the difference between an estimated budgetary cost of $2.71 for Stafford loans and $1.55 billion for direct loans. Actual savings would range in accord with different assumptions from $620 million to $1.47 billion. The GAO attributed the expected savings to the absence of in-school interest subsidies and special allowance payments to lenders. (Note: under the present Administration's proposal, the practice of relieving students of making interest payments while in school would continue.)

Peat Marwick Direct Loan Program Analysis

Contradictory findings were subsequently posited when the accounting firm of KPMG Peat Marwick reviewed the GAO report and methodology in March, 1992 and issued a direct loan program analysis that concluded there would be no federal monetary savings (in pure economic terms as distinct from budget scoring) by replacing the GSL with a direct lending program. Rather, a direct loan program would increase federal costs $267 million per year for an initial one-year $9 billion cohort of loans. Also during that initial year, colleges and universities would face $286 million in un-reimbursed costs associated with implementing and administering such a program. Hence, the analysis concluded that the GAO report was misleading in pure economic terms.

More specifically, the Peat Marwick study asserted that the GAO cost analysis understated the costs of a direct lending program by underestimating the Department of Education's administrative costs, underestimating servicing fees, erroneously including loan origination and insurance fees as receipts when such fees would be eliminated in the proposals the GAO was studying, failing to include transition costs to the Department and

the schools, treating costs transfers as cost savings, underestimating defaults, and failing to include incremental borrowing costs.

The study also charged the GAO with overestimating costs of the Stafford program by failing to include reinsurance payments paid by guarantors to the Department (equivalent to .25% or .50% of the loan amount paid), overstating special allowance payment expenses, and overstating default costs.[69]

Finally, the report warned that there would be risks associated with a disruption of the present system and flow of capital, and that there would be risks to the institutions both in the form of unknown administrative costs and liabilities.

Sallie Mae Assessment of Costs

In its report, "An Assessment of the True Economic Costs of Direct Loans," Sallie Mae concluded that the direct lending program would be more expensive than the GSL program. For its part, Sallie Mae avoided a cost projection keyed on a scoring of federal budget savings. Instead, it sought a study of the total economic costs that would be borne by the government, the institutions, and students. The report concluded that under direct lending, costs would be shifted from the government to the states, schools, and students; that these would exceed the federal government's scored budget savings; and in times of low interest rates the government could realize a profit from lending to students at rates in excess of its borrowing costs, but it would lose money when interest rates were high.

With respect to the first of these assertions, the Sallie Mae report maintained that "nearly $1.5 billion in new costs (origination, administrative, and start-up costs) will be shifted to school originators. These costs must be borne by either state budgets, increased tuition, or cuts in other school budget components." The report continued, "In essence, replacing the existing GSLP with direct loans is a form of reverse revenue sharing -- certain federal administrative costs would be shifted to the states, schools, and students."[70]

The Sallie Mae assessment was based on three cost simulations: "The Government Case" (applies the most recent Congressional Budget Office interest rate forecast for 1994-1999); "The Current Rate Case" (applies actual interest rates as of November, 1992, with rates increasing over five years as projected by the CBO); and the "Historic Rate Case" (applies historical -- 1981-1992 -- actual average rates)[71]

In terms of program cost differences, under the first scenario (The Government Case) Sallie Mae estimated that direct loan program related costs would exceed GSL program costs by approximately $966 million. There would be a government budget savings of $522 million, which would be achieved by transferring the aforementioned $1.5 billion in start-up and administrative costs to the schools.

Under the second scenario, (The Current Rate Case) direct lending program costs were projected to exceed GSL costs by $6.2 billion. In this setting the government would pay no special allowance and minimal interest subsidies in the GSL program, while in direct lending the government's borrowing and operating costs would exceed interest paid for the entire life of the loans.

The third scenario (The Historic Rate Case) projected direct lending program costs to exceed GSL program costs by $6.5 billion. Essentially, in this case, the interest earned on the loans would be $5.1 billion less than it cost the government to borrow.[72]

Congressional Research Service Report

In a February, 1993 report, "Federal Family Education Loans: Reduced Costs, Direct Lending, and National Income," the Congressional Research Service also challenged the assumption that direct lending would lead to significant cost savings. According to the leading paragraph of the report's Summary:

> "The proposal to convert the current guaranteed loan program to direct Federal lending aims to reduce budget outlays and increase national income. If, however, the current program structure provides lenders a competitive return, there are neither real budget savings nor national income increases from conversion to direct lending. Any increased funding available for public spending would be directly offset by reduced private sector income. This shift of lenders' net income to the public sector would not be a budget gain, for it represents nothing more than the failure of Federal bookkeeping to record outlays for taxpayers' assumption of risk. National income would not be increased: no loanable funds would be freed to increase output and wealth." [Emphasis in the original.][73]

The report also fired a broadside at the present GSL programs, calling them inefficient. It implied that the solution, however, did not lay in the direction of direct lending. Rather, high program costs are in part a function of the program's provision of a more than competitive rate of return to lenders, a practice that could be fixed within the confines of the current program structure, and of loan defaults.[74] The report noted that the Congress has continually adjusted the special allowance downward without inducing an appreciable decrease in student access to loan funds. "From 1985 to 1986, the SAP was set at 3.5 percentage points over the bond-equivalent yield of 91 day T-bills. The rate was then lowered to 3.25 percentage points, and, most recently in October, 1992, to 3.1 percentage points." It also noted that the 1989 GAO report, "Lower Subsidy Payments Could Achieve Savings Without Affecting Access," suggested that the margin could be reduced to 3.0 percentage points without significantly affecting the financial sector's willingness to make student loans.[75]

The fundamental issue was a national policy that "overlays subsidies to correct for capital market imperfections with those intended to produce external benefits." This, the CRS report implied, is bad policy.[76]

Virtually all of the reports raised questions about program administration. That issue evokes matters of cost and capacity. The latter of the two comprises the subject of the next section.

IV. PROGRAM ADMINISTRATION CONSIDERATIONS

In its report, the CRS stated that "Little is known about the relative administrative costs of public versus private provision of student loans." The report points to the root of the causes of uncertainty about the massive administrative changes associated with a shift from GSLs to direct lending in the following observations. They are worth quoting at length here:

> "Two factors might be important in judging the likelihood of genuine administrative cost savings from switching to a direct lending program. First, many [private] firms have entered the market to automate, computerize, and streamline loan servicing, spurred to some extent by the numerous potential buyers (private lenders) of these services under the current program. This competitive market has generated a steadily declining servicing cost per loan . . . It is uncertain whether creation of a monopoly lender (the Federal Government) would be successful in stimulating a competitive servicing market.
>
> "Second, the incentives facing public and private managers are very different. The private manager's rate of wage increase and the return to investors in private lending and secondary market institutions are dependent upon producing a profit, which provides strong motivation for cost minimization. In contrast, the public manager generally does not benefit from cost minimization; in fact, higher cost generates a larger budget and more people to manage, factors often associated with a public manager's wages. The impact of these incentives on cost might be significant even if a direct lending program continued to contract for loan servicing."[77]

The CRS writers then turned to concerns about the salaries and benefits paid to managers at Sallie Mae and to returns earned by stockholders. They argued that if these did exist, they were the likely results of an interest subsidy that may have been too generous over the years and of lenders and secondary markets striving to reduced administrative and servicing costs on loans, and thereby increase profits. These, however, would not represent a case for direct lending, but, rather, a successful effort to privatize a public service. They noted, "[When the present system was created] The public sector determined that an adjustment was necessary in the allocation of the nation's resources [establishing the guarantee program with its interest subsidies], in this case using more of the pool of scarce savings for postsecondary loans. The job of delivering the loans was given to the private, rather than the public, sector perhaps partly in the expectation that the former might perform it at least cost."[78]

Uncertainty about the Department of Education's capacity to administer a comprehensive direct lending program is ubiquitous. The KPMG Peat Marwick "Direct Loan Analysis" identified eleven Department tasks that would be added or enhanced under direct lending (determining school eligibility, processing fund requests, reviewing loan applications, reviewing promissory notes, monitoring enrollment status and address

changes, default prevention, loan servicing, default collections, paying schools an administrative allowance, reconciling school fund balances, and monitoring school compliance).[79] It noted that the Department has publicly stated that it is not equipped to assume the increased administrative and oversight responsibilities under a direct loan program. The writers cited Congressional testimony to that effect by quoting Senate Permanent Subcommittee on Investigations of the Committee of Governmental Affairs Chairman Sam Nunn:

> "It is not an exaggeration to say that we have heard no testimony or seen any documents that suggest the Department has done even an adequate job in managing and overseeing its student loan program responsibilities. . ."

KPMG Peat Marwick observed that the Subcommittee's 1991 report, "Abuses in Federal Student Aid Programs," "labeled the Department's role in the financial aid programs a 'dismal record,' noting 'pervasive and persistent problems in at least five areas,' including program administration and management.[80]

In its report on direct lending, Sallie Mae cited the GAO estimate that the government could score budget savings by enacting a direct lending program, but it also noted that the agency "recently warned (December, 1992) that 'the inventory of known problems in the Department's administration of guaranteed student loans raises questions about its ability to adequately manage a direct lending program. The Department needs accurate financial and information management systems for it to not only manage the guaranteed loan program but to properly implement the demonstration program.' The GAO concluded that the Secretary should proceed 'cautiously with the implementation of the direct lending demonstration program to ensure its proper implementation and subsequent evaluation.' The recent Sallie Mae cost estimate, along with the caution from the General Accounting Office, demonstrate the need to fully test the direct loan program before dissolving the existing GSLP."[81]

Finally, the most recent statement [at the time of writing] on this subject is contained in the GAO's March, 1993 financial audit of the Department of Education's GSLP's internal controls.[82] The audit revealed internal control weaknesses that resulted in ineffective accounting, controlling, and reporting of the results of the GSLP's operations. The GAO cited "material weaknesses in the Department's ability to obtain accurate and reliable data on the GSLP." The audit also identified problems with the program's structure, particularly respecting the guaranty agencies' role and compensation. The report concluded that the "GAO is making several recommendations to the Congress and to the Secretary of Education to help strengthen the Department's accounting and internal control systems related to the GSLP. GAO is also recommending that the Secretary direct the Assistant Secretary of Postsecondary Education to prepare a comprehensive plan on the role of the guaranty agencies and the manner in which they are compensated. . ."[83]

It is tempting to continue beating this dead horse, as it is an issue on which all sides express at least some uncertainty. Reactions to the prospect of Department

administration are both anecdotal and pervasive. There was no shortage of the former among the people interviewed. But there also were examples of the latter. Most, for example, believe that the single-most important independent variable in the present program complexity is the Department's penchant for detail and accountability. More than one respondent argued that the Department is more tightly focused on process than product; the result is myriad regulations and audit requirements and the threat of liability if standards are not met. There is little more that can be profitably added to the wealth of minutia on this subject.

But there is need for balance. Thus, this section of the narrative concludes with one final reference, a 1990 Stafford loan collection study conducted by American Management Systems for the Department of Education. The objective of the study was to provide data that could be used to determine whether it was in the best Federal Government fiscal interest to assign accounts to the guarantor agencies or the Department of Education for collection. The study found that the Department's record in this effort, while perhaps not as good as the guarantors', was perhaps not as bad as might have been expected. For example, "On an aggregate basis, the GAs marginally outperformed ED. GAs in the aggregate collected more (gross and net) and converted more accounts into repayment than ED. [But] . . . On an individual GA vs. ED basis, differences vary more significantly. In terms of net recovery rate, four of the ten GAs (HEAF, Ohio, Pennsylvania and Washington) recovered more than ED while ED recovered more than six GAs (California, Georgia, Illinois, New Jersey, and New York)." The report continued with other findings of a comparable nature.[84]

In the end, should direct lending be fully instituted, the Department, as would most governmental agencies, probably would rise to the occasion. The obvious question is: at what cost? That question has both fiscal and policy dimensions. Having reviewed the material on the former, attention is directed to the latter.

Policy Issues Associated with Program Administration

A disquieting tendency to generalize is prominent among the discussions surrounding guaranteed vs. direct lending. This is particularly apparent when the subject involves such generic terms as "lenders" (which comprise a wide variety of banks and financial institutions, large and small, estimated to total more than 10,000), "institutions" (which similarly encompasses a wide variety of large and small colleges and universities and other postsecondary education providers, public and private, non-profit and proprietary, estimated at more than 8,000), "secondary market institutions" (of which there are at least 35), and 45 state or nonprofit entities (also representing a wide variety of types operating out of an equally wide variety of settings).

Part of the difficulty of assessing the relative merits of the two approaches to student lending relates to the diversity in this enormously eclectic amalgamation of participants. The only players displaying greater variance are, of course, the estimated 22 million students who have obtained loans.

The fact is that different institutions display different capacities to manage direct lending programs (large universities may have sufficient staffs to mange the program;

smaller institutions probably do not). Different guarantors provide different services, in addition to those mandated by the Department of Education. With such a variety of interested lenders and service organizations, variety in forms, procedures, schedules, and other management accoutrements might be expected. This variety has caused problems, however, and it is one of the problems advocates of direct lending want to solve, especially those who work in large universities and who must deal with a number of out-of-state organizations as they process loans for their students. Simplification is an essential requirement, and people on both sides of the argument agree on its importance. National loan processing standards with uniform rules and procedures would provide at least some degree of simplification.[85]

There is another issue here. The variety of associations listed above is a function of the competitive involvement of private organizations and public and quasi-public entities in a public-private enterprise. It also is a function of the unique political and economic cultures of each of the participating states. Just as each state has addressed the political-educational relationship with its schools and institutions with a distinctive set of coordinating or governing boards (or, in a couple of cases, no statewide educational policy agency), each of which has a distinctive balance of responsibilities and authority, so has each empowered a public or quasi-public entity to represent the interests of its denizens in the vitally important student loan area.

In its July, 1986 Guaranty Agency Survey, the New York Higher Education Services Corporation (HESC) classified guaranty agencies into seven types:

State Education Department (5);
State Postsecondary Education Coordinating Board (5);
Separate State Agency (17, including Iowa);
Private Non-Profit Agency (18, including HEAF and USAF);
Public Authority (3);
Non-Profit Agency Chartered by State Statute (6);
and Public Non-Profit Corporation (1).

Fifteen have been in business more than 20 years; 13 for 10 to 20 years, and the rest for less than ten years (in 1985). Some manage other programs (e.g., merit-based scholarships and fellowships, need-based grants, work-study, etc.) and, in addition to performing the technical tasks of processing applications, certifying, pre-claims processing, default collection, conducting audits to prevent fraud and abuse, ensuring the exercise of due diligence, and assisting with school-lender relations, these organizations provide a variety of other services. These include information dissemination, arranging lender and school workshops and seminars, providing technical assistance to lenders and schools, interpreting regulations, distributing promotional material, handling billing for lenders, preparing accounts for the secondary market, counseling students to reduce over-borrowing and default incidence, etc.[86] These are the agencies whose future is placed most in doubt in the proposed direct lending program, as their funding source is eliminated, and as they are replaced by the Department of Education and, as some

suggest, service agencies submitting the lowest bid, and as the states are taken out of the equation.

Essentially, a system of undergraduate higher education finance has evolved in the United States that combines important roles for the government at both the state and national levels, parents, and students.[87] Substantial changes in the sources of funding for colleges and universities can have important indirect consequences.[88] In their review of national student aid policy, Michael McPherson and Morton Schapiro (respectively, of Williams College and the University of Southern California, co-authors of the definitive Brookings Institution study, *Keeping College Affordable*) address the issue of "fungibility," defined as the "process of reorganizing internal funding when earmarked funds are received." Essentially, any increase in funds earmarked for a particular purpose will be captured by the institution for other purposes. To the extent that complete fungibility exists, an increase in earmarked funding will have the same effect as an increase in unrestricted income.[89]

The matter is not perfectly applicable here, since student loan funds probably would not qualify as restricted funds in the pure sense. The subject is broached because of the dependence relationship it implies. What follows is speculative. Institutions of higher learning are dependent on the revenues that come in the form of tuition and fees, and students have become increasingly dependent on student loans to meet those costs. The proposed direct lending program would render the relationship between the federal government and the institution much more direct than at present, as the state-sponsored intermediary agencies are eliminated or set aside. Just as cost control is propelling the phase-in to direct lending, one can envision the extension of other such imperatives through the Department of Education as it manages the program. Enormous pressure could be brought directly to bear on institutions to control costs in order to continue in the program. Tuition increases, faculty productivity, institutional efficiency all become potential targets in that setting. All of these require continuing public attention, of course. The question is whether the associations, the states, or the Department of Education are to do this. The old "golden rule" cliche — the one who provides the gold makes the rules — comes to mind.

IV. CONCLUSIONS AND RECOMMENDATIONS

Some suggest that the present rush to direct lending constitutes an overdue wake-up call for the GSL program. This one may be too late. The consensus among people close to the scene is that fundamental restructuring in the federally-supported loan programs is inevitable: the only question is how. In that sense, the train has left the station.

Less certain is its destination. The present main track is headed toward the complete replacement of the GSL with a federally administered DSL. The schedule also is clear: replacement is to occur by 1997.

This seems true. But if it is not clear by now that enormous uncertainties attend the attainment of that destination, this report has failed to communicate. There is another

track, one that leads to a demonstration project, evaluation, and a decision on the results. The case for taking that train is compelling.

It may help to place matters in perspective. In this country, little by way of policy change occurs either comprehensively or only after careful and complete study of all the possible courses of action and their possible consequences. Rarely if ever are policy questions either resolved by decree or treated as intellectual problems, where policy development is approached in isolation of the operation of political considerations.[90] Because of omnipresent and competing interests, incrementalism and compromise are the usual modes. The accomplishment of a full-fledged direct lending program by fiat is not likely to occur, the popularity of train metaphors notwithstanding. There is an opportunity afforded by the demonstration project, however, to test the alternative courses of action and consider their possible consequences.

Divorced from the Capitol's frenetic pace, several futures can be envisioned; these also suggest available options. The first involves the precipitous replacement of the GSL program with DSL. This seems to be the present course. It is most likely to occur if an equally precipitous flight of lenders strengthens the self-fulfilling prophesy.

A second future entails continuation of the GSL program, with appropriate modifications, while an effective demonstration of direct lending proceeds. This could lead either to a stronger GSL program rendered more efficient by the experiences and competition aroused by an effective demonstration project, which would constitute the third future, or to a DSL program tested and developed and found to be superior to the GSL, which represents a more desirable restatement of the first.

The fourth future is the evolution of parallel GSL/DSL programs, operated in a continuously competitive relationship, which occurs from a responsible and balanced demonstration effort.[91]

The last of these pushes the envelop a bit. People are not used to thinking in terms of permanently operated parallel private and public programs directed to the same social purposes. But it can be argued that while "Reinventing Government," a philosophy of considerable interest to the present administration, and which is highly critical of the non-competitive governmental provision of services, would not be expected to lead to the elimination of one of the few privately-operated government programs, it also does not presume the complete privatization of an enterprise. The operative term is "competition," and student loans may be an area in which parallel -- public and private -- programs could be a way of delivering services, especially in view of the substantial governmental and private sector investments that already have been made.[92]

The least desirable means for arriving at whatever future unfolds would be the presumptive dismissal of the present program through a single-minded phase-in of a direct lending program. The more desirable means is through a combination of approaches composed of a carefully developed, effectively managed, and objectively evaluated demonstration project, and the implementation of mandated and subsequently competitively-driven modifications in the GSL program, with the results of those changes also objectively evaluated at the end of the test period.

The key word is "test." Even people who are considered proponents of direct lending accept the need for this. In his 1992 testimony at the House hearings on direct

lending, Arthur Hauptman offered this: "What is needed in this debate now is less rhetoric and more thoughtfulness about how a direct loan program might actually work. The critics of direct loans are right when they say it is neither feasible nor desirable at this time to cash out the existing program and to replace it with an untried idea where few of the details have been worked out. . . It is also critical that the direct lending option be set up to allow for adequate evaluation and testing. . . The option should be large enough to allow for adequate testing of different approaches. Institutions which participate should be allowed sufficient latitude in trying different kinds of direct lending approaches. The terms and conditions to student borrowers should be the same as in the GSL program to provide a level playing field. One possibility would be to test direct lending in several designated states and to allow state agencies to act as direct lenders for students at nonparticipating institutions."[93]

Whatever one's preference, the present rush to full phase-in of direct lending is disquieting, on the one hand, while the proposed demonstration project may be too small or too narrowly circumscribed to constitute a fair test of direct lending, on the other. One also might question whether the Department of Education, with heavy stakes in any result, is the appropriate entity to administer and evaluate the program. The present course, whether full phase-in or inadequate piloting, may not be fully satisfying to anyone.

Both the arguments that have been presented in favor of direct lending and the concerns that have been raised about it constitute a strong case for testing it. But that is all they comprise. Anything more than that is risky.

The present decision framework is dominated by budget containment, expediency, and politics. It is a difficult environment either to penetrate or to influence. But it is reasonable to insist that any program of modification or replacement address a number of principles.[94] These are:

1. First, do no harm. Students' accessibility to loans to attend and complete college should not be impeded or endangered.

2. The decision process should involve a reliable demonstration and testing program conducted in accord with standards established by and under the purview of a credible independent entity and in a process that permits the presence of representatives of present program participants.

3. The testing effort should be sufficiently comprehensive to ensure reliability of findings; it should address both direct student lending and modifications in the present system, and it should allow the implementation of industry-proposed cost savings during the demonstration period.

4. Evaluation at the end of the demonstration period should include the possibility of parallel private- and government-operated systems (i.e., both GSL and DSL).

5. While repayment options should be pursued, the possibility of incorporating community service repayment and income contingent repayment into both types of programs should be considered.

6. Whatever approach to student lending is adopted, it should be continued as an entitlement program.

7. Loans are not a very good substitute for grants, especially for low-income students. Federally-subsidized loan programs, whatever their form, should not displace grants based on need.

8. Education is the constitutional responsibility of the states, and either program must preserve an important role for them.

9. Direct lending, if implemented, should allow institutions the options to originate, administer, and service loans, enter into consortial relationships to do so, or contract with alternative originators and servicers. If they opt to service and collect loans, they should receive the same reimbursement as alternate servicers. Timely and appropriate training should be provided.

10. To the extent possible, there should be a single set of rules and regulations carried forward from the present program. Participants' liability should be limited to areas within their control.

11. Institutions should be allowed the option of choice, if a parallel program is adopted, or the latitude to phase in the new program at their own pace, within an agreed upon overall schedule, if it is not.

12. Cost savings from a new approach should be reflected in proportionate student fee reductions.

13. "Reverse revenue sharing" should not occur; program costs should not be assigned to the states or to the institutions.

The concluding opinion of this report is that the proposed demonstration project should go forward in a process governed by these principles. But it should remain what Congress has made it, a pilot program, until it can be demonstrated that direct lending is the better alternative.[95] If that occurs conclusively at the end of the test period, and the operation of parallel systems is deemed impractical, the present system should be replaced and a transition into the new program completed. If the demonstration fails to show that direct lending is the more effective approach, then the present private-public partnership, exhibiting the modifications adopted during the demonstration period, should be continued.

ENDNOTES

1. As translated by Darius Lyman. Syrus was a Roman author who flourished during the First Century B.C. Other possibly pertinent maxims might be: "It is well to moor your bark with two anchors" (Maxim 119); "You should hammer your iron while it is glowing hot" (Maxim 262); "There are some remedies worse than the disease" (Maxim 301); and "It is a bad plan that admits of no modification" (Maxim 469).

2. Alice in Wonderland. This quotation has been seen so much that it's use is becoming hackneyed. Its fit with the present circumstance, however, over-ruled any hesitation to use it once more.

3. (PL 102-325) Overall authorized loan volume for the demonstration project was $500 million, which the Department of Education estimated would allow approximately 275 institutions to participate.

With respect to federal student aid, several other relevant changes were included among the reauthorization provisions. Among them were:

> Re-authorization of Pell grants (maximum authorized grant is $3,700 for academic year 1993-94; $3,900 for 1994-95; $4,300 for 1995-96, and $4,500 for 1996-97 -- Note, these are the authorized levels; the actual maxima are determined by appropriations; the figure for 1992-93 is $2,400; the minimum authorized grant is $400; eligibility also is extended to less-than-half-time students)
>
> Authorization of a new Presidential Access Scholarship program (open to students eligible for Pell Grants who demonstrate academic achievement and preparation)
>
> Extension of the Supplemental Educational Opportunity Grant (SEOG), College Work-Study, Perkins Loans, and State Student Incentive Grants (SSIG) programs for five years
>
> Continuation of the Stafford Loan program (with increases in loan limits for second-year and beyond and graduate students; reduction in the interest rate -- ninety-one day Treasury Bill notes plus 3.1 percent [formerly 3.25 percent] with a cap of nine percent [current rate is eight percent for the first four years of repayment, rising to ten percent thereafter]; and consolidation of deferments [provided for the in-school period, periods of unemployment -- up to three years -- and economic hardship -- also up to three years)
>
> Authorization of a new Stafford Loan for students who do not qualify -- on the basis of need -- for the in-school interest subsidy at the same interest rate as regular Stafford Loans (borrowers will be charged a 6.5 percent combined origination fee and insurance premium [the program does contain a subsidy when

the special allowance paid to lenders exceeds the interest rate charged]

Increases the authorized maximum in the Parent Loans for Undergraduate Students (PLUS) program from $4,000 to the annual cost of education less other assistance and caps the interest rate at ten percent

Authorizes an annual Supplemental Loan for Students (SLS) limit of $4,000 for undergraduates in their first two years and $5,000 thereafter, up to $10,000 (previously $4,000) and caps the interest rate at 11 percent.

New Guaranteed Student Loan options also were mandated. For example, new borrowers (Federally Insured Student Loan, FISL, Stafford, or SLS program) must be offered the option of graduated or income sensitive repayment; the loan consolidation program is extended with repayment period tied to level of indebtedness (e.g., borrowers with more than $60,000 of debt will be given 30 years to repay); institutions with a GSL cohort default rate of 25 percent or greater for three consecutive years will be ineligible to participate in the program; proprietary schools that receive more than 85 percent of their revenues from Title IV funds are eliminated from the student aid programs; programs of less than 600 hours are eliminated from eligibility unless the institution has a graduation and job placement rate of more than 70 percent; "ability to benefit" provisions are tightened; a single formula for determining need is to be used for all federal programs; application forms and systems are to be standardized, etc. This summary of major provisions is based on an August, 1992 National Association of Independent Colleges and Universities (NAICU) summation and various other reports.

4. 34 CFR Part 685. After the initial summary, the proposed rules refer to this as the "Federal Direct Student Loan Program (FDSLP)" rather than "FDLDP," which would be the acronym for the demonstration project. This has led to some apparent confusion, as people confuse the rules for the demonstration project as rules for a full-fledged direct lending program. Comments on the proposed rules are due not later than May 17, 1993, as, under the authorizing legislation, final regulations are required by July 1, 1993, with institutional applications due by October 1, 1993.

5. Quotations are from the "What We Must Now Do" portion of the published report, particularly page 92.

6. Clinton Administration, "Vision. . .," op. cit., p. 92.

7. The situation is in flux. The following summary of the President's program is based on information graciously provided by Brett Leif, of NAICU, on April 19, 1993, via FAX.

At the time of writing, the President's budget called for Congressional action that would phase-in a federal direct loan system to replace the present GSL programs by 1997. The FY 1994 budget requests $149,279,000 for this effort, of which $22,179,000 would be for loan subsidies; 23,100,000 would go to loan servicing, collection, and other administrative costs, and $104,100,000 would be designated for transition costs. (The

funds for loans are off-budget, a point that prompts contention about program cost estimates.)

The phase-in program would initially involve approximately 250 schools with a loan volume of $776 million by FY 1995. The numbers would increase to approximately 1,500 schools and $5.1 billion in loan volume in FY 1996, and 3,750 institutions and $12.9 billion in 1997. Students would be afforded a variety of repayment options, including income-contingent repayment.

Participating institutions would not be responsible for servicing or collection; rather, these functions would be performed by Department of Education contractors.

Participating institutions would certify eligibility, disburse loan funds, execute a promissory note, provide loan counseling, and maintain data on disbursement transactions.

If institutions did not meet as yet undefined standards of administrative capacity, their origination activities would be performed by "alternative originators."

Also according to Mr. Leif's summary, "continuing federal subsidies for the direct lending program would cover the projected difference between the loan repayments received from borrowers, and the repayments the Department of Education would make to the U.S. Treasury on the debt associated with financing the loans. As with the current system, Stafford Loan borrowers would not be required to make interest payments while in school. The Department would pay Treasury for these interest costs at the government borrowing rate, rather than at the higher rate paid to lenders under the current program. . .

"The special allowance payments associated with the current program would be eliminated, as would the administrative allowances to guarantee agencies. Federal administrative costs would support loan servicing, collection on defaulted loans, and oversight of administrative activities at postsecondary institutions."

A summary dated April 10, 1993 by Jill Zackman (Faxed by the Iowa College Student Aid Commission on April 15, 1993 advised that under the budget, funding for higher education will decline from FY 1993. The President was reported to have requested budget authority of $11.5 billion in FY 1994 (down from $12.7 billion the previous year) for Pell grants, guaranteed student loans, direct loans, and the work study program. When the federal funds are combined with bank loans, school aid and state aid, the actual amount available to students would increase from $27 billion to $28 billion.

According to this summary, "Particularly hard hit is the Pell grant program, which provides grants for need students to attend college. Clinton would freeze the maximum grant at $2,300 per year." This is down from $2,400 the previous year, and well below the recommended by the National Commission on Responsibilities for Financing Postsecondary Education.

Estimates will continue to fluctuate until the budget request is released.

8. This is probably a good place to note that a number of people with knowledge and opinions about the direct lending/guaranteed loan polarity were consulted during the preparation of this report. All were helpful, and many provided copies of pertinent materials, often by FAX. A few asked to remain anonymous, unusually because their

organization had not yet taken a position. Others had no such reservations. They include: Michelle Durand Adams (MidAmerica Student Loan Company); Gary Andeen (Oregon Independent Colleges Association); Bob Barak (Iowa Board of Regents); Patrick Callan (California Higher Education Policy Center); Carl Donovan (Northwest Education Loan Association); Lola Finch (Washington State University); Eric Godfrey (University of Washington); Arthur Hauptman (Independent Consultant, Washington D.C.); Dave Irwin (Washington Friends of Higher Education [Independent College Association]); Sam Kipp, III (California Student Aid Commission); Linda Lamar (Washington Higher Education Coordinating Board, Student Financial Aid Office); Brett Lief (National Association of Independent Colleges and Universities); Steve McCullough, (Iowa Student Loan Liquidity Corporation); Aims McGuinness (education Commission of the States); James Mingle (state Higher Education Executive officers); Gary Nichols (Iowa College Student Aid Commission); Shirley Ort (Washington Higher Education Coordinating Board, Student Financial Aid Office); John Parker (Drake University); Mark Warner (University of Iowa); Desna Wallin (Clinton Community College, Iowa); and Jane Wellman (National Association on Independent Colleges and Universities). All of these people, named and unnamed, were enormously helpful and informative. Much of what they said is reflected in the pages of this report, although they bear no responsibility for any inaccuracies. Grateful appreciation is expressed to all.

9. U.S. Senate, "Federal Direct Student Loans: Hearing Before the Committee on Labor and Human Resources," February 25, 1992 (GPO, Washington, D.C., 1992).

10. This might be the place to insert a comment about the use of acronyms. There are few policy areas in which they abound in greater assortment and number than this. In this report, the use of abbreviations and acronyms is generally but not completely eschewed. The use of the abbreviation, DSL, will apply often to Direct Student Loan programs, as will the abbreviation, GSL, to Guaranteed Student Loans. In other cases, acronyms and abbreviations will be used parsimoniously.

11. Serious thought was given to placing the program details in an appendix. That idea was abandoned, however, when it became apparent during the field interviews that knowledge of program details was not likely to be consistent among the members of the most probable reading audience.

12. Janet S. Hansen, "The Roots of Federal Student Aid Policy," in Jamie P. Merisotis, Editor, The Changing Dimensions of Student Aid (Jossey-Bass, San Francisco, New Directions for Higher Education series Number 74, Summer, 1991), pp. 4-6.

13. Janet Hansen, op. cit., pp. 4-5.

14. Janet Hansen, op. cit., p. 5.

15. Janet Hansen, op. cit., pp. 5-6.

16. Although not usually recognized, the FFELP also contains the Consolidation Loan Program which allows borrowers with multiple student loans to combine them and extend the repayment period up to as much as 25 years, thus reducing their monthly payments. Hence, there are actually five loan programs in this category. See National Commission on Responsibilities for Financing Postsecondary Education, Final Report, "Making College Affordable Again" (Washington, D.C., February, 1993), p. 42.

17. Barbara Miles and Dennis Zimmerman, Congressional Research Service, "Federal Family Education Loans: Reduced Costs, Direct Lending, and National Income" (Library of Congress, Washington D.C., February 22, 1993. The Government Accounting Office report, "Guaranteed Student Loans: Eliminating Interest Rate Floors Could Generate Substantial Savings" (GAO, Washington, D.C., July, 1992), p. 4, describes the arrangement before the enactment of the 1992 amendments as follows: "Legislative formulas determine the interest rates on guaranteed student loans. Stafford loans carry a two-tiered rate; 8 percent is charged to eligible first-time borrowers through the first four years of repayment and 10 percent thereafter. If the yield on 91-day T-bills plus 3.25 percent goes below 10 percent during the fifth and subsequent repayment years, monthly payments remain unchanged but excess interest payments are used to reduce loan principal. As such, the interest rate during this repayment period becomes a variable rate with a 10-percent cap. PLUS and SLS loans carry variable interest rates equal to the bond equivalent yield on 52-week T-bills plus 3.25 percent, capped at 12 percent. Consolidated loans carry a fixed interest rate equal to the weighted average of the loans consolidated or 9 percent, whichever is higher.

18. House Committee on Education and Labor, "Defaults in the Federal Guaranteed Student Loan Programs," Hearings before the Subcommittee on Postsecondary Education, Serial No. 100-86 (GPO, Washington, D.C., 1988) p. 2.

19. GAO, "Eliminating Interest Floors. . ., op. cit., pp. 2-3. According to the CRS, op. cit., p. CRS-4, Stafford loans accounted for 76.3 percent of all FFEL loan principal guaranteed by the government during fiscal year 1992.

20. CRS, op. cit., p. CRS-4.

21. CRS, op. cit., pp. CRS-5 through CRS-7.

22. CRS, op. cit., p. CRS-5.

23. CRS, op. cit., CRS-7.

24. GAO, "Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement," GAO/AFMD-93-20 (GPO, Washington, D.C., March, 1993), p. 2.

25. "Direct Student Loans Could Save Money and Simplify Program Administration" GAO/T-HRD-92-8 (GAO, Washington, D.C., October 29, 1991), p. 1.

26. National Center for Education Statistics, "Digest of Education Statistics, 1991" (GPO, Washington, D.C., 1991) Tables 297 and 298. According to the Congressional Budget Office, 31 percent of the full-time dependent undergraduates in postsecondary institutions during Fall, 1986 were recipients of loans. See "Student Aid and the Cost of Postsecondary Education" (CBO, Washington, D.C., January, 1991) Table B-2.

27. Cited in GAO, "Financial Audit . . .," op. cit., p. 9.

28. "Defaults in the GSL . . .," op. cit., p. 2.

29. "Making College Affordable . . ., " op. cit., p. 24. The Commission cites the Department of Education's "FY 1990 Guaranteed Student Loan Programs Data Book" (GPO, Washington, D.C., 1991).

30. "Making College Affordable. . .," op. cit., p. 25.

31. These are Department of Education figures quoted in several sources, including "Making College Affordable. . .," op. cit., pp. 25-26, and Merisotis, op. cit., p. 24.

32. S. Hrg. 102-515, February 25, 1992 (GPO, Washington, D.C., 1992), p. 13.

33. Janet Hansen, op. cit., p. 4.

34. "Making College Affordable. . .," op. cit., p. 66, et. seq..

35. "Analysis of Alternative Loan Proposals, p. 1. Dr. Hauptman graciously provided a copy of this testimony by FAX for consideration in the development of this report.

36. "Making College Affordable. . .," op. cit., p. 66.

37. "Making College Affordable. . .," op. cit., p. 44.

38. "Making College Affordable. . .," op. cit., p. 45.

39. "Making College Affordable. . ., " op. cit., p. 46.

40. "Making College Affordable. . .," op. cit., pp. 66-67.

41. Senate Direct Student Loans Hearings, op. cit., p. 14.

42. Senate Direct Student Loan Hearings, op. cit., p. 14.

43. Senate Direct Student Loan Hearings, op. cit., p. 16.

44. Senate Direct Student Loan Hearings, op. cit., p. 16.

45. Senate Direct Student Loan Hearings, op. cit., pp. 14-15.

46. Brett Leif, April 19, 1993, op. cit., p. 10.

47. "Report to the Student Loan Industry," March, 1992, p. 2.

48. "Federal Family Income Loans . . .," February 22, 1993, op. cit.

49. "Federal Family Income Loans . . .," February 22, 1993, op. cit.

50. For the most part, these are paraphrased from "Financial Aid Issues of Major Concern to the California Student Aid Commission and to the Students and Postsecondary Institutions it Serves, by Sam Kipp III, "The Direct Loan Program is not a Wise Investment, by the Northwest Education Loan Association, and from "Top Ten Concerns About Direct Government Lending," provided by MidAmerica Student Loan Company.

51. NASFAA,"An Examination of Direct Lending," October, 1991, Sallie Mae, "Proposal for Direct Loans: An Uneasy Case," p. 31.

52. NASFAA, "An Examination. . .," op. cit., p. 31.

53. Arthur Hauptman describes the Bush Administration's position on this as one of its "three blind mice," which deserve to be put to sleep." Then he adds, "The question of the competence of the Department of Education to administer a program of this size is a valid one, especially if direct loans were run as a highly centralized program. But a direct loan program could and should be highly decentralized, with many of the administrative responsibilities farmed out to the state agencies or other nonprofit groups at a fraction of the cost of what the government currently pays the banks." February 6, 1992 testimony before the House Education and Labor Committee, Subcommittee on Postsecondary Education, "Analysis of Alternative Loan Proposals," p. 3.

54. GAO/HRD-91-122BR (General Accounting Office, Washington, D.C., September, 1991), p. 2.

55. "Financial Audit. . .," op. cit., p. 2.

56. Senate Hearings on Direct Lending, op. cit., p. 14.

57. Analysis of the House Committee version of the Reauthorization Act, September 30, 1991, p. 4.

58. Based on Sallie Mae evaluations at ten schools, "Minimum, up-front hardware and software upgrade cost estimates range from $12,500 to $107,000. Estimated annual incremental staffing and administrative expenses range from $109,000 to $360,000.

Estimated first year incremental operating costs average about $219,000. Estimated annual costs indicate that schools will incur additional per loan processing costs ranging from $54 to $198." Data provided by the Iowa College Student Aid Commission.

59. Some of those interviewed referred to benefits to students that might occur through simplified administration, particularly elimination of the need for short-term borrowing while they await arrival of the actual loan check. They speak of a three day draw down in the manner of Perkins loans.

60. op. cit.

61. GAO, "Direct Loans. . .," op. cit., p. 2

62. "The Budget Process and Its Effects on the Debate over the Guaranteed Student Loan Program and Direct Government Loans," Prepared for the Education Finance Council, April, 1993, p. i.

63. Peat Marwick, "The Budget Process . . .," op. cit., p. i.

64. Peat Marwick, "The Budget Process . . .," op. cit., p. i. The February, 1993 report, "Federal Family Education Loans: Reduced Costs, Direct Lending, and National Income," by the Congressional Research Service, discussed in more detail later in this report, also noted that the GAO report "to a large extent reassigned administrative costs, making them a neutral factor in the analysis of direct versus private lending loans." The CRS, however, considered this reasonable. "Administrative expenses that under the current program are recorded in the Federal budget as interest outlays to compensate private lenders for these expenses, would, under a direct lending program, be reassigned to their own outlay line in the Federal budget. No genuine budget or economic change occurs unless the per unit administrative cost differs between direct and private lending programs." See p. CRS-20.

65. Peat Marwick, "The Budget Process. . .," op. cit., pp. i-ii.

66. Peat Marwick, "The Budget Process . . .," op. cit., p. ii.

67. GAO, "Student Loans. . .," op. cit., FN p 3.

68. GAO, "Student Loans . . .," op. cit., p. 5.

69. Peat Marwick, "Direct Loan . . .," op. cit., pp. 1-3.

70. Sallie Mae, (no date), p. 2.

71. Sallie Mae, "An Assessment . . .," op. cit., p. 6.

72. Sallie Mae, "An Assessment . . .," op. cit., pp. 6-7.

73. CRS, Library of Congress, first summary page, unnumbered.

74. CRS, "Federal Family Education Loans. . .," op. cit., p. CRS-1.

75. CRS, "Federal Family Loans . . .," op. cit., p. CRS-15. The GAO reference is to GAO/HRD-92-7, January, 1992.

76. CRS, "Federal Family Education Loans. . .," op. cit., p. CRS-1.

77. CRS, "Federal Family Education Loans. . .," op. cit., pp. CRS-20 and CRS-21.

78. CRS, "Federal Family Loans . . .," op. cit., p. CRS-21.

79. Peat Marwick, "Direct Loan Program Analysis," op. cit., p. 31.

80. Peat Marwick, "Direct Loan Program Analysis," op. cit., p. 5.

81. Sallie Mae, "An Assessment. . ., op. cit., p. 3.

82. GAO, "Financial Audit. . .," op. cit., pp. 2-4.

83. GAO, "Financial Audit . . .," op. cit., p. 4

84. Final Report, p. 4.

85. Deloitte Touche, "Report . . .," op. cit., p. 4.

86. The survey report lists no publication site. HESC is located in Albany, New York.

87. Michael S. McPherson and Morton Owen Schapiro, Keeping College Affordable, (Brookings, Washington, D.C., 1991), p. 133.

88. McPherson & Schapiro, Keeping College. . . , op. cit., p. 190.

89. McPherson & Schapiro, Keeping College . . ., op. cit., p. 67.

90. See David Braybrooke and Charles E. Lindbloom, A Strategy of Decision: Policy Evaluation as a Social Process (Free Press, New York, 1963) p. 40.

91. This proposition is based on a telephone conversation with Arthur Hauptman during the course of the present report's development.

92. "Reinventing Government," of course, is from David Osborne and Ted Gaebler's book, Reinventing government: How the Entrepreneurial Spirit is Transforming the Private Sector (Addison -Wesley, Reading, MA., 1992). The comments about parallel systems and presumption of complete privatization are essentially Arthur Hauptman's, from a lengthy telephone conversation about direct lending versus GSLs that occurred shortly after the

completed income tax forms were delivered to the post office on April 15, 1993. As noted previously, Art Hauptman also has suggested the possibility of joint venture involving the farming out of administrative responsibilities to the state agencies or other nonprofit groups.

A petition prepared by Tom Rutter, UC-San Diego, and some 100 financial aid administrators, raised this question: Can the participants in the student loan business develop a new student loan program which incorporates the best attributes of the direct and guaranteed loan programs? For instance, could the lenders use a line-of-credit system with the campuses to create a direct, guaranteed student loan for which the application processing and eligibility is determined at the campus?" A copy of this material was provided by the Northwest Student Loan Association (Seattle) for possible reference in this report.

In its October, 1991 paper, "An Examination of Direct Lending," NASFAA also suggested the possibility of a mixed program. The proposal it described would use a "Direct Loan delivery system to replace only the highly subsidized, need-based Stafford Loans to students. It would retain the GSL structure -- private loans and State-level guarantee agencies -- for delivery of the less subsidized and non-need based PLUS and SLS loans which more closely resemble private sector loans." See p. 4.

93. Hauptman, "Analysis of. . . ," op. cit., p. 4.

94. This is an approach pursued by other organizations as well. For example, NAICU established a task force that developed a draft set of principles for consideration by its board. NASFAA is reported to be pursuing a similar course. Time permitting, it would be worthwhile to consider the possibility of a combining these into a single list, upon which all parties could agree.

95. Based on Samuel M. Kipp, III, "Financial Aid Issues of Major Concern to the California Student Aid Commission and to the Students and Postsecondary Institutions it Serves," no date, p. 3. This material was provided by its author on April 16, 1993 by facsimile transmittal.

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